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SENSITIVE
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SUBJECT: TYMOSHENKO'S CONTROVERSIAL 2010 BUDGET

SENSITIVE BUT UNCLASSIFIED, NOT FOR INTERNET DISTRIBUTION

¶1. (SBU) Summary: Ukrainian Prime Minister Yulia Tymoshenko's draft 2010 budget projects a deficit equivalent to 4% of GDP (exclusive of funds for bank recapitalization) and contains moderate increases in social spending, as well as provisions for transfers to economic sectors hit by the country's current crisis. The most profound change is a technical mechanism that would allow transfers of funds directly from central authorities to local, city-level governments, bypassing oblast-level governors, who are subordinate to the President. President Yushchenko is unlikely to approve this provision. The current political standoff in the Rada (Ukraine's parliament) may preclude final passage of the draft budget before the January 1 due date. Even if it mustered enough support in the Rada, the budget likely would be amended after the January 2010 presidential elections. End summary.

BUDGETARY PARAMETERS

¶2. (SBU) The draft budget provides for revenues of UAH 284.8 billion and expenditures of UAH 324.3 billion, equaling annual increases of 19% and 20.6%, respectively. The upper limit for the deficit is projected by the GOU to be UAH 46.7 billion (roughly $5.6 billion) or 3.97% of GDP, a figure within the IMF's required target. Nonetheless, this amount could become a source of controversy, as President Yushchenko had called on the government to limit the 2010 budget deficit to 3% of GDP.

¶3. (SBU) The proposed budget would transfer UAH 17.9 billion to cover the Pension Fund's 2010 deficit, an increase over the UAH 13 billion allocated for this purpose in 2009. It also foresees that Ukraine would repay UAH 31.7 billion in external debt.

¶4. (SBU) The budget's proposed subsidy for Naftohaz, covering the differential between the cost of Russian gas and the price afforded to Ukrainian residential consumers, is UAH 6.52 billion. This amount is lower than the UAH 7.7 billion that was ultimately approved for Naftohaz in 2009 through a March 11 Cabinet of Ministers' resolution, but higher than original 2009 budget figures of UAH 1.6 billion.

¶5. (SBU) In addition to core spending, the GOU has also accounted for expected increases in financing needs for bank recapitalization, equal to UAH 50.5 billion. This amount is expected to cover recapitalizations for an undisclosed number of top Ukrainian domestic banks, as well as provide "top-off" money for previously nationalized banks that have suffered further deterioration of their loan portfolios. (Note: As in 2009, when UAH 18.6 billion was transferred from bank recapitalization funds to Naftohaz via treasury bills, the GOU considers money set aside for bank recapitalization to be fungible. The IMF did not include bank recapitalization funds in its estimate of the GOU's 2009 core budget deficit, a position it will likely adopt in 2010. End note.)

PLUGGING THE GAP

¶6. (SBU) In order to finance the 2010 budget deficit, the GOU would rely on record levels of domestic borrowing -- up to UAH 104 billion ($12.4 billion), a figure that may prove unrealistic, given the slow revival of the domestic bond market. There are also concerns that National Bank of Ukraine (NBU) purchases of domestic treasury bills would become the primary source of debt financing, a move that would increase inflationary pressures. The government plans foreign borrowings at the comparatively low amount of UAH 15 billion ($1.8 billion), yet even this may turn out to be wishful thinking, given Ukraine's current inability to access external financing. The GOU's revenue target for privatizations is an ambitious UAH 10 billion ($1.2 billion). However, the GOU's active efforts to privatize Odessa Portside Plant, several regional power distribution companies (the so-called "oblenergos"), and Ukrtelecom, may mean these revenues could materialize.

OPTIMISTIC MACRO ASSUMPTIONS

¶7. (SBU) The draft budget foresees 2010 GDP growth at 3.76% and inflation at 9.7%. Rada budget committee and Our Ukraine faction member Pavlo Zhebrivskiy commented that a 3% growth figure would be more realistic, with prospects dim for an uptick in the critical chemical production sector. Zhebrivskiy also said that inflation would likely reach 12-13%, as the GOU plans to impose higher residential gas rates, per the IMF agreement.

¶8. (SBU) Local analystQhave focused on the GOU's "overly optimistic" exchange rate assumptions of UAH 7.5/$1. The hryvnia

has faced nothing but downward pressure of late and currently is being traded at around UAH/USD 8.4-8.5. Furthermore, most corporate foreign debt due in 2009 was rolled over to 2010, suggesting that demand for dollars will remain high and depreciation pressures for the hryvnia will continue. Using a more realistic exchange rate translates into increased government expenditures, especially for gas and foreign debt payments, perhaps pushing the 2010 budget deficit well above 4%. The average price for imported Russian gas projected in the budget is $260 per thousand cubic meters (tcm). (Comment: Oil prices would need to fall in 2010 for this figure to be a realistic forecast. The 2009 average price will be approximately $230/tcm, though Ukraine received 20% off the base gas price in 2009, per the January 2009 gas contracts. Without that discount, the average price in 2009 would have been roughly $288/tcm. End comment.)

SOCIAL SPENDING

¶9. (SBU) The draft budget contains a 16% increase in the minimum wage and a 7% increase in the minimum pension, both of which would be implemented gradually during the course of the year. It also provides 20% wage increases for education and public healthcare workers. Still, these increases have been criticized by Viktor Yanukovich-led Party of Regions (PoR) as too little. PoR has been pushing its plan to significantly increase social spending (between UAH 8-40 billion), a move blocked by Tymoshenko's BYuT and others.

ECONOMIC DEVELOPMENT

¶10. (SBU) The draft budget would expand Ukraine's economic development fund, known as the stabilization fund, raising it from UAH 19.9 billion in 2009 to UAH 27 billion for 2010, though this line item has long been criticized as non-transparent and a tool for "manual management" of budgetary resources. Analysts tell us that revenue sources for the stabilization fund are also questionable, as UAH 19.6 billion or 1.7% of GDP would be transferred via borrowing and privatization.

¶11. (SBU) Stabilization fund expenditures would be allocated to

Euro 2012 infrastructure projects (UAH 6.69 billion), public housing (UAH 1.15 billion), agriculture support (UAH 3.38 billion), and military equipment purchases (UAH 3.38 billion). In addition to funding economic development programs via the stabilization fund, the GOU would also use budget resources to support the coal industry to the tune of UAH 21.6 billion ($2.6 billion), a figure that is nearly twice the value of the annual output of all state-owned mines. This proposal has been roundly criticized for heightening structural imbalances in Ukraine's coal sector.

LOCALITIES AFFECTED

¶12. (SBU) The proposed budget would alter the way in which the central government would transfer funds to local budgets. According to the draft budget, the central government and localities would bypass the 26 oblast-level governors, who are subordinated to the President, in favor of direct communication between localities and the Cabinet of Ministers, who would be the ultimate arbiters of all budgetary transfers. This proposal has raised eyebrows in Kyiv, particularly regarding the technical capacity of over 12,000 cities, towns, and villages to manage increased accounting responsibilities. Moreover, President Yushchenko will likely be adamantly opposed to the change, as it would strip his appointed governors' ability to allocate and distribute resources. Reportedly, the IMF also views this proposed reform with skepticism, considering that it has been hastily and improperly prepared by the government.

RADA (AND BUDGET) BLOCKED

¶13. (SBU) Yanukovich has announced that the PoR will continue to block the Rada from voting on the 2010 budget until the 2009 budget is amended to increase social spending. Taking the PoR's indefinite blockage together with controversial elements of the proposed 2010 budget, most observers believe Tymoshenko's fiscal program has little chance of approval. Deputy Head of the Presidential Secretariat Oleksandr Shlapak described the budget as being full of "pseudo reforms" and consisting of "election promises, trickery, and cowardice." Furthermore, analysts project that even if the proposed budget were adopted, Ukraine's new president would likely be forced by fiscal imbalances to initiate significant amendments.

¶14. (SBU) If the 2010 budget is not adopted by December 31, monthly budget allocations will be funded at one-twelfth of 2009

allocations. This would provide the GOU significant discretion to manage expenditures, since the monthly allocations would be distributed to the state treasury in bulk. Nonetheless, Tymoshenko has announced that the Cabinet of Ministers will draft a separate resolution on the implementation of an interim 2010 budget if the proposed budget is not passed. Observers have expressed concern that Tymoshenko would use a Cabinet resolution to ram through the new rules on direct transfers to localities, even if President Yushchenko ultimately vetoed the 2010 budget based on his opposition to that provision.

COMMENT

¶15. (SBU) The IMF appears to have been supportive of Tymoshenko's draft 2010 budget, perhaps because the GOU continues to promise an increase in gas prices for residential customers, which the IMF has said could provide an extra 1% of GDP in revenue in 2010. Whether Tymoshenko will fulfill her pledge to the IMF to raise household gas prices just prior to the formal launch of her presidential campaign and at the beginning of winter heating season is yet to be seen.

¶16. (SBU) Possible increases in domestic gas prices notwithstanding, the IMF will still need to push for pension and other social spending reform, given the limited availability of domestic and external financing and the possibility that privatization revenue may not be forthcoming. Yet, with the election season fast approaching and little success to date on these goals, we are not optimistic about the prospects for serious pension

reform this year, even with IMF insistence.

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